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No. 95-323

In the Supreme Court of the United States

OCTOBER TERM, 1995

UNITED STATES OF AMERICA, PETITIONER

v.

THOMAS R. NOLAND, TRUSTEE FOR DEBTOR
FIRST TRUCK LINES, INC.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Taxes and tax penalties that arise after the date of a bankruptcy filing are "administrative expenses" of the bankruptcy estate. 11 U.S.C. 503(b)(1)(B) and (C). As "administrative expenses," such taxes and tax penalties are entitled to first priority in the distribution of the estate. 11 U.S.C. 507(a)(1). This case presents the following question:

Whether the statutory priority that Congress conferred on the government's claim for postpetition tax penalties may—under the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1)—be subordinated to the claims of general unsecured creditors solely because a court determines that it would enhance "fairness" and "justice" to pay the general creditors first.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	2
Statutory provisions involved	2
Statement	2
Introduction and summary of argument	8
Argument:	
The "principles of equitable subordination" codified in Section 510(c) of the Bankruptcy Code do not, in the absence of inequitable misconduct by the government, authorize the subordination of governmental claims for postpetition tax penalties	9
A. The doctrine of equitable subordination does not permit a court to disregard the statutory priorities that Congress has enacted merely because the court concludes that a different set of priorities would be more equitable, fair or just	9
B. The court of appeals misapplied the doctrine of equitable subordination in subordinating a claim in the absence of inequitable conduct by the claimant	18
Conclusion	30

TABLE OF AUTHORITIES

Cases:

Benjamin v. *Diamond*, 563 F.2d 692 (5th Cir. 1977)	15
Boteler v. *Ingels*, 308 U.S. 57 (1939)	10, 20, 21, 24
Burden v. *United States*, 917 F.2d 115 (3d Cir. 1990)	6, 15, 21, 22, 24
Carpenter v. *Wabash Ry.*, 309 U.S. 23 (1940)	13, 14
Columbia Ribbon Co., In re, 117 F.2d 999 (3d Cir. 1941)	10-11, 14, 15

Cases—Continued: Page

Comstock v. *Group of Institutional Investors*, 335 U.S. 211 (1948) 5, 11, 12
Credit Industrial Corp., In re, 366 F.2d 402 (2d Cir. 1966) 16, 18
Louisville Trust Co. v. *Louisville, N.A. & C. Ry.*, 174 U.S. 674 (1899) 28
Mansfield Tire & Rubber Co., In re, 942 F.2d 1055 (6th Cir. 1991), cert. denied, 502 U.S. 1092 (1992) .. 5
New Jersey v. *Anderson*, 203 U.S. 483 (1906) 14, 21
Newton National Bank v. *Newbegin*, 74 F. 135 (8th Cir. 1896) 26
Nicholas v. *United States*, 384 U.S. 678 (1966) 10, 20, 21, 23, 24
Norwest Bank Worthington v. *Ahlers*, 485 U.S. 197 (1988) 13
Pepper v. *Litton*, 308 U.S. 295 (1939) 5, 11, 12, 25
Samuel Chapman, Inc., In re, 394 F.2d 340 (2d Cir.), cert. denied, 393 U.S. 923 (1968) 21
Schultz Broadway Inn v. *United States*, 912 F.2d 230 (8th Cir. 1990) 6, 24
Simonson v. *Granquist*, 369 U.S. 38 (1962) 21
Stebbins v. *Crocker Citizens National Bank*, 516 F.2d 784 (9th Cir.), cert. denied, 423 U.S. 913 (1975) 8, 9, 11, 13, 14, 15, 19
Stirling Homex Corp., In re, 579 F.2d 206 (2d Cir. 1978), cert. denied, 439 U.S. 1074 (1979) 26, 28
Taylor v. *Standard Gas & Electric Co.*, 306 U.S. 307 (1939) 5, 11
United States v. *Killoren*, 119 F.2d 364 (8th Cir.), cert. denied, 314 U.S. 640 (1941) 16
United States v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (10th Cir. 1995), cert. granted, No. 95-325 (Dec. 1, 1995) 24, 25, 27
United States v. *Sotelo*, 436 U.S. 268 (1978) 20

Cases—Continued: Page

United States Department of Interior v. *Elliott*, 761 F.2d 168 (4th Cir. 1985) 24
Virtual Network Services Corp., In re, 902 F.2d 1246 (7th Cir. 1990) 6, 24, 25, 27

Statutes:

Bankruptcy Act, § 57(j), 11 U.S.C. 93(j) (1976) 21
Bankruptcy Code, 11 U.S.C. 101 *et seq.*:
11 U.S.C. 103(b) 20
11 U.S.C. 503(b)(1)(B) 2, 18
11 U.S.C. 503(b)(1)(C) 2, 4, 8, 10, 18, 19, 20, 22
11 U.S.C. 507 ..... 10, 29
11 U.S.C. 507(a)(1) 2, 3, 8, 10, 18, 19, 20
11 U.S.C. 507(a)(7) 5
11 U.S.C. 510 10
11 U.S.C. 510(a) 10
11 U.S.C. 510(b) 10, 28
11 U.S.C. 510(c) 2, 3, 5, 6, 8, 9, 16, 17, 18, 29
11 U.S.C. 510(c)(1) 3, 4, 10, 16, 22
11 U.S.C. 726 ..... 10, 19, 20, 23, 29
11 U.S.C. 726(a) 2, 10
11 U.S.C. 726(a)(1) 10, 18, 19
11 U.S.C. 726(a)(4) 19
11 U.S.C. 726(a)(6) 28
Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 6
26 U.S.C. 6651 18

Miscellaneous:

2 Collier Bankruptcy Manual (3d ed. 1995) 11
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124 Cong. Rec. (1978):
p. 32,398 ..... 3, 6, 16, 25
p. 32,416 ..... 17, 22
p. 33,998 3
p. 34,016 ..... 17, 22
H.R. 8200, 95th Cong., 1st Sess. (1977) 17
H.R. Rep. No. 595, 95th Cong., 1st Sess. (1977) 17

Miscellaneous—Continued: Page

A. Herzog & J. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83 (1961) 11, 21

Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L. Rev. 487 (1993) 29

Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II (1973) 20

S. Rep. No. 989, 95th Cong., 2d Sess. (1978) 17, 22

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-20a) is reported at 48 F.3d 210. The opinion of the district court (Pet. App. 26a-33a) is unreported. The opinion of the bankruptcy court (Pet. App. 34a-55a) is reported at 141 B.R. 621.

JURISDICTION

The judgment of the court of appeals (Pet. App. 23a) was entered on March 2, 1995. A petition for rehearing was denied on June 16, 1995 (Pet. App. 24a). The petition for a writ of certiorari was filed on August 25, 1995, and was granted on December 1,

1995. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a) of the Bankruptcy Code, 11 U.S.C. 503(b)(1)(B) and (C), 507(a)(1), 510(c) and 726(a), are reproduced at Pet. App. 56a-58a.

STATEMENT

1. In 1986, First Truck Lines, Inc., filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code and continued to operate its business as debtor-in-possession. During the following two years, the debtor failed to pay the social security and unemployment taxes accruing from its operations. After efforts to reorganize the debtor proved unsuccessful, the bankruptcy case was converted to a Chapter 7 liquidation in 1988. Respondent was appointed trustee at that time (Pet. App. 2a).

The Internal Revenue Service filed a request for payment of the taxes, interest and tax penalties that accrued after the filing of the bankruptcy petition. Respondent stipulated that, under Section 503(b)(1)(B) of the Bankruptcy Code, 11 U.S.C. 503(b)(1)(B), the unpaid postpetition taxes and interest are "administrative expenses" that are entitled to first priority in distribution of the assets of the estate under Section 507(a)(1) of the Code, 11 U.S.C. 507(a)(1). Respondent asserted, however, that postpetition tax penalties are not entitled to priority in distribution. The parties applied to the bankruptcy court for resolution of that dispute (Pet. App. 2a-3a).

2. The bankruptcy court acknowledged (Pet. App. 40a) that Section 503(b)(1)(C) of the Bankruptcy Code

expressly defines postpetition tax penalties to be "administrative expenses" (11 U.S.C. 507(a)(1)). The court observed, however, that Section 510(c)(1) of the Bankruptcy Code, 11 U.S.C. 510(c)(1), provides that a court may (*ibid.*),

> under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim * * *.

Because Section 510(c)(1) "does not expressly define the phrase 'equitable subordination,'" the court stated that it would "resort to an examination of the legislative history" (Pet. App. 42a-43a).

At the time the Bankruptcy Code was enacted in 1978, the floor statement of the House sponsor stated (Pet. App. 43a, quoting 124 Cong. Rec. 32,398 (1978) (Rep. Edwards), and citing 124 Cong. Rec. 33,998 (1978) (Sen. DeConcini) (emphasis added by court)):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim is of a status susceptible to subordination, such as a penalty* or a claim for damages arising from the purchase or sale of a security of the debtor.

The bankruptcy court concluded that this legislative history evidences that Congress intended that a tax "penalty"—like any other "penalty"—would be "susceptible to subordination" under the "principles of equitable subordination" codified in Section 510(c) of the Code (Pet. App. 43a). The court deemed it

irrelevant that in 1978 Congress provided a specific statutory priority for postpetition tax "penalties" (11 U.S.C. 503(b)(1)(C)). The court also found it irrelevant that the United States had not been "guilty of inequitable conduct" in asserting its claim. The court concluded that the government's claim for tax penalties is subject to equitable subordination simply because it is designed to enforce a "penalty" (Pet. App. 44a).

In applying the "principles of equitable subordination" codified in Section 510(c)(1) of the Bankruptcy Code, the court stated that its task is to "weigh the equities of the various claims on a case-by-case basis" to determine whether subordination is appropriate (Pet. App. 44a). The court began its "weighing" or "balancing" of "the equities" by distinguishing between the pecuniary losses incurred by general commercial creditors and the nonpecuniary loss represented by statutory tax penalties. Finding that the Bankruptcy Code contains a "preference for compensating actual loss claims," the court held "that the equities tilt in favor of subordinating the postpetition non-pecuniary loss tax penalties sought by the IRS" to the claims of general unsecured creditors of the debtor (*id.* at 49a-50a). Otherwise, the court noted, the assets available for payment of the general unsecured creditors would be reduced by the amount of the tax penalties that, by statute, were given first priority in distribution as administrative expenses of the estate (*ibid.*).

3. The district court affirmed (Pet. App. 26a-33a). The court stated that all types of priority claims—including first priority claims for administrative expenses—may be subordinated under the "principles of equitable subordination" that Congress codified in

Section 510(c) of the Bankruptcy Code (Pet. App. 29a). The court agreed with the bankruptcy court that the "principles of equitable subordination" are not restricted to remedying inequitable misconduct by creditors. The court held, instead, that the "principles of equitable subordination" permit a tax "penalty" to be subordinated solely in order to promote the claims of other creditors who suffered pecuniary losses from their dealings with the estate (*id.* at 32a-33a).

The district court emphasized that "other creditors * * * provided value to [the debtor] and will not receive that for which they bargained if the IRS is to be given priority for sums which do not represent out of pocket losses to it" (Pet. App. 33a). For this reason, the court concluded that "the equities tip in favor of subordinating the IRS's claim for tax penalties in this case" (*ibid.*).

4. a. The court of appeals affirmed (Pet. App. 1a-20a). The court noted that this Court has applied "principles of equitable subordination" in bankruptcy cases only in situations involving "creditor misconduct" (*id.* at 5a, citing *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948); *Pepper* v. *Litton*, 308 U.S. 295 (1939); *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307 (1939)). The court also noted that, in *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055 (1991), cert. denied, 502 U.S. 1092 (1992), another panel of that circuit held that the government's claim for prepetition excise tax liabilities—which have *seventh* priority in distribution under Section 507(a)(7) of the Bankruptcy Code—is *not* subject to equitable subordination solely in order to improve the "fairness" of the distribution to other creditors (Pet. App. 5a-6a). The court held, however,

that none of those decisions is controlling in the context of this case, which concerns the application of "principles of equitable subordination" to a tax "penalty" (*id.* at 6a).

The court of appeals followed the analysis of the bankruptcy court in concluding that the legislative history of Section 510(c) indicates that a statutory "penalty" is properly subject to equitable subordination. The court noted that the floor statement of the House sponsor of the 1978 Bankruptcy Reform Act reflected that Congress intended to "follow existing case law and leave to the courts development of this principle" (Pet. App. 11a, quoting 124 Cong. Rec. 32,398 (1978) (Rep. Edwards)). The court acknowledged that there was no "existing case law" as of 1978 that supported the equitable subordination of tax penalty claims. The court ascribed this, however, to the fact that, "prior to 1978, nonpecuniary loss tax penalty claims against the estate of the bankrupt were not allowed by law" (Pet. App. 12a). The court noted that three more recent decisions have held that claims for *pre*petition, *non*priority tax penalties may be equitably subordinated even though no governmental misconduct occurred (*id.* at 14a, citing *Burden* v. *United States*, 917 F.2d 115, 119-120 (3d Cir. 1990); *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990); and *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990)). The court stated that the reasoning of those decisions applied directly to this case (Pet. App. 19a):

> We do not see the fairness or the justice in permitting the Commissioner's claim for tax penalties, which are not being assessed because of

> pecuniary losses to the Internal Revenue Service, to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not. Further, assessing tax penalties against the estate of a debtor no longer in existence serves no punitive purpose. Because of the nature of postpetition, nonpecuniary loss tax penalty claims in a Chapter 7 case, we believe such claims are susceptible to subordination. To hold otherwise would be to allow creditors who have supported the business during its attempt to reorganize to be penalized once that effort has failed and there is not enough to go around. Furthermore, to hold otherwise could result in rewarding the debtor-in-possession, the party who failed to pay the taxes on time, to the detriment of the creditors. The debtor-in-possession remains liable individually for the postpetition tax penalties. However, if the bankruptcy court cannot subordinate these penalties in the appropriate case, the creditors, and not the debtor-in-possession, will have borne the burden of paying the penalties.

b. Judge Batchelder filed a concurring opinion (Pet. App. 21a-22a). She stated that the court had correctly determined that the "principles of equitable subordination" permit subordination of priority tax claims. In her view, the plain language of the statute mandates that conclusion and "nothing requires us to delve into the legislative history" (*id.* at 22a):

> Section 726(a) [see note 1, *infra*] explicitly, clearly, and unambiguously makes the distribution of the property of the estate subject to the provisions of § 510. Postpetition nonpecuniary

loss tax penalties are therefore subject to equitable subordination. End of story.

INTRODUCTION AND SUMMARY OF ARGUMENT

The court of appeals held in this case that postpetition tax penalties are not to be given the *first* priority that Congress expressly provided for such claims in Sections 503(b)(1)(C) and 507(a)(1) of the Bankruptcy Code. The court held that claims for such penalties are instead to be denied *any* priority and are to be subordinated even to general unsecured claims against the debtor. The court stated that its conclusion results from application of the judge-made "principles of equitable subordination" that Congress codified in Section 510(c) of the Bankruptcy Code. The court reasoned that, because tax penalty claims do not compensate a specific, economic loss incurred by the government, such claims should—as a matter of "fairness" and "justice"—be equitably subordinated to the claims of "creditors who suffered actual losses" (Pet. App. 19a, 20a).

By holding that a tax "penalty" is to be subordinated to all other claims against the debtor's estate, the decision in this case annuls and reverses the precisely opposite set of statutory priorities that Congress enacted. The decision thereby conflicts with the established rule that equitable subordination in bankruptcy does *not* permit a court "to contradict statutory or common law when [it] feels a fairer result may be obtained by application of a different rule" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 787 (9th Cir.), cert. denied, 423 U.S. 913 (1975)). The doctrine of equitable subordination does not confer a power of statutory nullification on the

bankruptcy courts. Instead, the doctrine has the appropriate and narrow role of deterring "conduct either in acquiring or asserting the claim which is itself inequitable" (*id.* at 788). That traditional rationale obviously would not justify subordination of the tax penalty claims in this case.

By assuming a broad authority to realign statutory priorities based upon a "weighing" or "balancing" of the "equities," the court of appeals has fundamentally transformed and misapplied the judge-made doctrine of "equitable subordination" and unloosed that doctrine from its proper moorings. If courts were permitted to determine, by "balancing" the "equities," whose claims are to be paid first and whose are to be paid last, the carefully constructed scheme of priorities in the Bankruptcy Code would be made superfluous.

ARGUMENT

THE "PRINCIPLES OF EQUITABLE SUBORDINATION" CODIFIED IN SECTION 510(c) OF THE BANKRUPTCY CODE DO NOT, IN THE ABSENCE OF INEQUITABLE MISCONDUCT BY THE GOVERNMENT, AUTHORIZE THE SUBORDINATION OF GOVERNMENTAL CLAIMS FOR POSTPETITION TAX PENALTIES

A. The Doctrine Of Equitable Subordination Does Not Permit A Court To Disregard The Statutory Priorities That Congress Has Enacted Merely Because The Court Concludes That A Different Set Of Priorities Would Be More Equitable, Fair Or Just

1. A postpetition tax penalty is defined by statute to be an administrative expense of the bankruptcy

estate. 11 U.S.C. 503(b)(1)(C). As an "administrative expense," such a penalty has "[f]irst" priority in the distribution of the assets of the estate. 11 U.S.C. 507(a)(1). See also 11 U.S.C. 726(a)(1).[1] As this Court has emphasized, the priority for postpetition tax penalties was enacted by Congress precisely because the enforcement of such penalties is an important and necessary measure for ensuring tax compliance in bankruptcy cases. See *Nicholas* v. *United States*, 384 U.S. 678, 694 (1966); *Boteler* v. *Ingels*, 308 U.S. 57, 61 (1939).

The priorities that Congress has established in the Bankruptcy Code for competing classes of claims apply "[e]xcept as provided in section 510" of the Code. 11 U.S.C. 726(a). Section 510 authorizes only three specific exceptions to the statutory ordering of priorities. First, any claim may be subordinated by agreement. 11 U.S.C. 510(a). Second, claims seeking rescission or damages from sales of the debtor's securities may be subordinated. 11 U.S.C. 510(b). Third, any claim may be subordinated to any other claim "under principles of equitable subordination." 11 U.S.C. 510(c)(1). The question presented in this case is thus not whether "principles of equitable subordination" *may* be applied to priority claims; instead, it is *what* those principles are and *how* they are to be applied to priority claims.

2. The judge-made doctrine of equitable subordination has a clear origin and a limited scope (*In re*

[1] This case involves a liquidation of the debtor's assets under Chapter 7 of the Bankruptcy Code (Pet. App. 2a). The priorities established in Section 507 are made applicable to bankruptcy cases under Chapter 7 by Section 726 of the Bankruptcy Code. See 11 U.S.C. 726(a)(1).

Columbia Ribbon Co., 117 F.2d 999, 1002 (3d Cir. 1941) (emphasis added)):

> [A] court of bankruptcy under its equitable powers may disallow or subordinate a particular claim in bankruptcy which, *because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant*, ought not in equity and good conscience to be allowed or paid on a parity with other claims.

See also *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d 784, 788 (9th Cir.), cert. denied, 423 U.S. 913 (1975). The issue that is to be resolved "under principles of equitable subordination" is whether (2 Collier Bankruptcy Manual ¶ 510.01[1], at 510-2 (3d ed. 1995)):

> harmful conduct [of the claimant] was directed at other creditors. If it was, the claim which is otherwise provable and allowable should be postponed until the claims of the creditors, who were harmed, have been satisfied.

See *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211, 229 (1948); *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939); A. Herzog & J. Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 85 (1961).

The limited scope of the doctrine of equitable subordination is reflected in the decisions of this Court. In *Taylor* v. *Standard Gas & Electric Co.*, 306 U.S. 307, 323-324 (1939), the Court held that the claim of a parent corporation against its subsidiary could be subordinated to the claims of preferred stockholders in the subsidiary "based on the equities of the case—the history of spoliation, mismanagement, and faith-

less stewardship of the affairs of the subsidiary by [the parent] to the detriment of the public investors." *Pepper* v. *Litton*, 308 U.S. at 308. In *Pepper* v. *Litton*, the Court held that the claim of a dominant shareholder of a bankrupt corporation could be subordinated to the claims of other creditors where the shareholder had breached his fiduciary duties and engaged in a "planned and fraudulent scheme" that damaged other creditors. *Id.* at 303-306. And, in *Comstock* v. *Group of Institutional Investors*, 335 U.S. 211 (1948), the Court reviewed those decisions and confirmed that "principles of equitable subordination" require the presence of creditor misconduct.

The issue in *Comstock* was whether the claim of a dominant shareholder against the bankrupt could be equitably subordinated even though there was no evidence of misconduct. The Court held that equitable subordination could not apply in those circumstances (335 U.S. at 229):

> It is not mere existence of an opportunity to do wrong that brings the rule into play; it is the unconscionable use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary that deprives the wrongdoer of the fruits of his wrong. On the findings in this case, the claim of [the parent] was the outgrowth of complicated but legitimate good faith business transactions, neither in design or effect producing injury to the petitioner or the interests for which he speaks.

The doctrine of equitable subordination thus provides a means to redress harmful misconduct of an individual claimant. The premise of any application of

the doctrine of "equitable subordination" to "creditor misconduct" is that Congress has measured the equities of competing classes of claims but has not measured the conduct of the individual creditors who assert those claims. See *Carpenter* v. *Wabash Ry.*, 309 U.S. 23, 28 (1940). Because Congress did not (and indeed cannot) take the conduct of individual creditors into account in enacting a bankruptcy distribution scheme, subordination of a particular claim based upon the inequitable conduct of a specific creditor does not contravene the legislative judgment that Congress has made concerning the relative priorities to be afforded to specified categories of claims. See *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787.

The doctrine of equitable subordination does not, however, authorize a court to disregard statutory priorities merely because the court concludes that a *different* ordering of priorities would enhance "fairness" or "justice" (Pet. App. 19a). "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 206 (1988). As the Ninth Circuit explained in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 787,

> it is important to keep in mind that the chancellor never did, and does not now, exercise unrestricted power to contradict statutory or common law when he feels a fairer result may be obtained by application of a different rule. Courts of equity have long applied standards of conscience to conduct on an individual basis to prevent formally proper but unconscionable applications of legal

> rules; they have not engaged in the practice of making abstract legislative judgments about the fairness of a result contemplated by the legislature's statutory scheme if it has otherwise been followed in good faith and without overreaching.

See also *In re Columbia Ribbon Co.*, 117 F.2d at 1002.[2]

This Court has noted that, in enacting the statutory priority scheme, Congress itself made a "reasonable classification of claims as entitled to priority because of superior equities." *Carpenter* v. *Wabash Ry.*, 309 U.S. at 28. The categorical balancing of equities that Congress made in adopting the Code's priority provisions may not categorically be displaced by the courts under the guise of "equitable subordination." As the Ninth Circuit stated in *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788, the doctrine of equitable subordination does not permit a court to say, "in effect * * *, 'No, the distribution scheme provided by the [Bankruptcy] Act is a mistake.'"

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[2] Similarly, in *New Jersey* v. *Anderson*, 203 U.S. 483 (1906), the Court rejected the assertion that a statutory priority for state taxes should not be recognized because it created an "injustice" for other creditors and gave the State an undue "advantage" (*id.* at 490):

> [C]onsiderations of this character, however properly addressed to the legislative branch of the government, can have no place in influencing judicial determination. It is the province of the court to enforce, not to make the laws, and if the law works inequality the redress, if any, must be had from Congress.

Courts therefore traditionally and consistently held that "[d]ecisions about the treatment of *categories* of claims in bankruptcy proceedings * * * are not dictated or illuminated by principles of equity and do not fall within the judicial power of equitable subordination." *Burden* v. *United States*, 917 F.2d 115, 122 (3d Cir. 1990) (Alito, J., concurring in part and dissenting in part; emphasis added).[3] See also *Benjamin* v. *Diamond*, 563 F.2d 692, 700 (5th Cir. 1977) (equitable subordination requires that "[t]he claimant must have engaged in some type of inequitable conduct"); *Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788 ("there must be conduct either

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[3] The Third Circuit has placed itself on both sides of this issue. In 1941, the court explained that the doctrine of equitable subordination does not authorize a court to adopt a priority scheme different from the statutory scheme based simply upon the court's "theory of equity." *In re Columbia Ribbon Co.*, 117 F.2d at 1002. Instead, the court explained, equitable subordination may be applied to "disallow or subordinate a particular claim in bankruptcy which, because of the fraudulent nature of the claim or the bad faith or improper conduct of the claimant, ought not in equity and good conscience to be allowed or paid on a parity with other claims." *Ibid.*

In 1990, the Third Circuit acknowledged that, "prior to the enactment of the Bankruptcy [Code] of 1978," the doctrine of equitable subordination had applied "only when there has been a showing of bad faith on the part of the creditor." *Burden* v. *United States*, 917 F.2d at 119. The court identified nothing in the text or history of the 1978 legislation to justify a departure from that historical understanding of equitable subordination. The court stated, nevertheless, that it was persuaded by several recent decisions holding that "creditor misconduct is not a prerequisite for equitable subordination." *Id.* at 120-121. See pages 24-28, *infra*. As described in the text, Judge Alito dissented from that part of the court's opinion.

in acquiring or asserting the claim which is itself inequitable in order to subordinate a claim"); *In re Credit Industrial Corp.*, 366 F.2d 402, 408 (2d Cir. 1966). As the Eighth Circuit stated in *United States* v. *Killoren*, 119 F.2d 364, 366, cert. denied, 314 U.S. 640 (1941), in reversing a decision that had applied "equitable subordination" to a claim for taxes, "[t]he plain mandate of the law cannot be set aside because of considerations which may appeal to referee or judge as falling within general principles of equity jurisprudence."

3. In 1978, Congress codified the judge-made doctrine of equitable subordination as Section 510(c) of the Bankruptcy Code. That provision states that bankruptcy courts may, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." 11 U.S.C. 510(c)(1).

By codifying the doctrine of equitable subordination, the statute did not enlarge the equitable authority that courts had previously exercised. The express language of the statute—which refers to "principles of equitable subordination"—indicates that Congress intended courts to exercise the limited equitable powers that had then been established in decisions of this Court and the courts of appeals. The floor statement accompanying Section 510(c)(1) confirms that Congress "intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle." 124 Cong. Rec. 32,398 (1978) (Rep. Edwards).

The text and history of Section 510(c) reflect a deliberate policy determination of Congress that "existing case law" was to be followed in applying

"principles of equitable subordination." In enacting the Bankruptcy Code in 1978, Congress considered and rejected statutory language that would have granted bankruptcy courts authority to subordinate claims on much broader grounds. The bill that first passed the House of Representatives contained a version of Section 510(c) that would have allowed any claim to be subordinated simply "on equitable grounds." H.R. 8200, 95th Cong., 1st Sess., § 510 (1977). The report accompanying the House bill emphasized that this language differed from the existing doctrine of equitable subordination, for it would permit the courts to order "subordination on any equitable grounds." H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977). The broad language of the House bill was deleted, however, from the final legislation. The phrase "under principles of equitable subordination" was substituted in its place. See S. Rep. No. 989, 95th Cong., 2d Sess. 74 (1978); 124 Cong. Rec. 32,416 (1978) (Rep. Edwards); *id.* at 34,016 (Sen. DeConcini).[4]

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[4] The Senate Report on the provision enacted as Section 510(c) states (S. Rep. No. 989, *supra*, at 74) (emphasis added):

> [A]ny subordination ordered under this provision must be based on principles of equitable subordination. These principles are defined by case law, and have generally indicated that *a claim may normally be subordinated only if its holder is guilty of misconduct.* As originally introduced, the bill provided specifically that a tax claim may not be subordinated on equitable grounds. The bill deletes this express exception, but the effect under the amendment should be much the same in most situations since, under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated.

The history of Section 510(c) thus confirms that Congress consciously elected to adopt only the "existing" principles of equitable subordination and rejected a broader equitable authority for the bankruptcy courts. That existing authority rejected application of equitable subordination to displace the categorical priorities enacted by Congress in the absence of particularized misconduct by a specific creditor. See pages 10-16, *supra*. See also *In re Credit Industrial Corp.*, 366 F.2d at 408; 3 *Collier on Bankruptcy* ¶ 510.01 (15th ed. 1995) ("The law in this area is of long standing, having been judicially created.").

B. The Court Of Appeals Misapplied The Doctrine Of Equitable Subordination In Subordinating A Claim In The Absence Of Inequitable Conduct By The Claimant

1. In the present case, the court of appeals acknowledged that the tax penalty claim was not derived from any "misconduct" of the government (Pet. App. 4a).[5] The court also recognized that Congress expressly provided first priority in the distribution of the assets of the estate for such tax penalty claims (*ibid.*, citing 11 U.S.C. 503(b)(1)(B) and (C), 507(a)(1), and 726(a)(1)). The court concluded, however, that Congress acted "unfairly" and "unjustly" in awarding first priority to the government's claims for postpetition tax penalties under Section

[5] Indeed, the claim in this case was derived from the debtor's failure to file a timely return (26 U.S.C. 6651), which represents "misconduct" by the debtor, not the creditor (the United States). Hence, the doctrine of equitable subordination, which applies only to creditor misconduct, has no application here.

503(b)(1)(C) and Section 507(a)(1). The court of appeals "in effect said, 'No, the distribution scheme provided by the Act is a mistake'" (*Stebbins* v. *Crocker Citizens National Bank*, 516 F.2d at 788). The court stated that it did not "see the fairness or the justice in permitting the Commissioner's claim for tax penalties * * * to enjoy an equal or higher priority with claims based on the extension of value to the debtor, whether secured or not" (Pet. App. 19a). For that reason, the court held that the tax penalty claim should not be given the "[f]irst" priority that Congress specified for that claim. The court held, instead, that the government's claim should be "equitably" subordinated even to the claims of unsecured general creditors (*ibid.*).

The court of appeals erred in applying the doctrine of equitable subordination to annul the statutory priorities established by Congress simply because the court believed that "fairness" and "justice" could be enhanced by a different distribution scheme. Congress directed that postpetition tax penalties are to be given "[f]irst" priority in distribution. 11 U.S.C. 507(a)(1); see 11 U.S.C. 503(b)(1)(C).[6] Even if there

[6] While Section 726(a)(1) preserves first priority in distribution for postpetition tax penalties in Chapter 7 cases (see note 1, *supra*), Section 726(a)(4) expressly subordinates prepetition tax penalties to general unsecured claims. Compare 11 U.S.C. 726(a)(1) with 11 U.S.C. 726(a)(4). The reasoning adopted by the court of appeals in this case is thus invalid for the additional reason that it conflicts with the carefully crafted distinctions that Congress made in enacting Section 726. By requiring subordination of postpetition tax penalties, the decision in this case relegated those penalties to the same status that Congress elected to apply *only* to prepetition tax penalties in Section 726.

were a basis to believe that it might be more "fair" to pay other creditors before postpetition tax penalties are paid, any dispute about the relative merits of alternative priority schemes is simply irrelevant to the task that the court of appeals properly had before it.[7] Congress authoritatively resolved that policy issue when it expressly provided a first priority for postpetition tax penalty claims in Section 503(b)(1)(C) and Section 507(a)(1). Moreover, as this Court explained in enforcing the priority for postpetition tax penalties in *Nicholas* v. *United States*, 384 U.S. at 694, Congress adopted that first priority for postpetiton tax penalty claims precisely because such penalties serve to enforce compliance with the tax laws in bankruptcy cases. See also *Boteler* v. *Ingels*, 308 U.S. at 61. That legislative judgment is obviously binding on the courts and may not be displaced by a court's differing perception of "equity" or "fairness" (Pet. App. 19a). See, *e.g.*, *United States* v. *Sotelo*, 436 U.S. 268, 279 (1978) ("we as judges cannot override the specific policy judgments made by Congress in enacting the statutory provisions with which we are

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Section 726 sets forth the order of distribution in cases under Chapter 7. See 11 U.S.C. 103(b); note 1, *supra*. In cases outside of Chapter 7, prepetition tax penalties are paid on a parity with general unsecured claims. Congress rejected proposals that would have required subordination of prepetition tax penalty claims in cases under all chapters. See *Report of the Commission on the Bankruptcy Laws of the United States*, H.R. Doc. No. 137, 93d Cong., 1st Sess. Pt. II, at 115, § 4-406(a)(3) (1973).

[7] In assessing the "fairness" of the statutory distribution scheme, the court of appeals wholly failed to consider the enforcement function served by tax penalties during the administration of the estate.

here concerned"); *New Jersey* v. *Anderson*, 203 U.S. at 490; note 2, *supra*.

2. In its decision in this case, the court of appeals sought to rely on the 1978 floor statement of Representative Edwards that "existing case law" permits subordination of "a claim * * * of a status susceptible to subordination, such as a penalty" (Pet. App. 11a). As Judge Alito correctly observed in his separate opinion in *Burden* v. *United States*, 917 F.2d at 123, however, that description of "existing case law" by Representative Edwards was simply incorrect. As of 1978, no court had held that tax "penalty" claims, or any other kind of "penalty" claims, were subject to equitable subordination. Prior to 1978, claims for *pre*petition tax penalties were disallowed by statute (not subordinated through exercise of a court's equitable powers) under Section 57(j) of the Bankruptcy Act, 11 U.S.C. 93(j) (1976). See *Simonson* v. *Granquist*, 369 U.S. 38, 40 (1962); Herzog & Zweibel, *supra*, 15 Vand. L. Rev. at 85-88 (noting the difference between claim disallowance and claim subordination). By contrast, claims for *post*-petition penalties incurred by the trustee or debtor in possession—the type of penalties involved in this case—were allowable and were given first priority in distribution of the bankruptcy estate. *Nicholas* v. *United States*, 384 U.S. at 692-695; *Boteler* v. *Ingels*, 308 U.S. at 61; *In re Samuel Chapman, Inc.*, 394 F.2d 340, 341-342 (2d Cir.), cert. denied, 393 U.S. 923 (1968).[8]

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[8] The majority and concurring opinions in this case (Pet. App. 12a-13a, 22a) thus simply erred in stating, without qualification, that penalty claims were disallowed under the former Bankruptcy Act.

Any misdescription of "existing case law" in the 1978 floor statement of Representative Edwards obviously does not alter the preexisting "principles of equitable subordination" that are to be applied under Section 510(c)(1). See *Burden* v. *United States*, 917 F.2d at 123 (Alito, J., concurring in part and dissenting in part). Moreover, although it is unclear what "penalty" Representative Edwards may have had in mind in asserting that penalty claims were of a status "susceptible to subordination," he obviously was not contemplating that postpetition tax penalty claims would be subordinated under Section 510(c)(1) when Section 503(b)(1)(C) of the *same* Act provides "[f]irst" priority for such claims. See 11 U.S.C. 503(b)(1)(C). Indeed, Representative Edwards went on to say in the next portion of his remarks (124 Cong. Rec. 32,416 (1978)):

> Since the House amendment authorizes subordination of claims only under principles of equitable subordination, and thus incorporates principles of existing case law, a tax claim would rarely be subordinated under this provision of the bill.

See also *id.* at 34,016 (Sen. DeConcini); S. Rep. No. 989, *supra*, at 74 (noting that, "under the judicial doctrine of equitable subordination, a tax claim would rarely be subordinated" for "a claim may normally be subordinated only if its holder is guilty of misconduct"); note 4, *supra*.

The suggestion that tax penalty claims are categorically of a "status susceptible to subordination" is also refuted by the careful distinctions that Congress made in providing disparate treatment for prepetition and postpetition tax penalties. Section

726 provides first priority for claims for *post*petition tax penalties but subordinates claims for *pre*petition penalties to general unsecured claims. See note 6, *supra*. The precisely formulated legislative judgment that Congress made in Section 726 may not be annulled by a judicial conclusion that "fairness" and "justice" require that some different priority scheme apply.

As this Court has noted, Congress has long provided first priority for postpetition tax penalties as a "legitimate means to enforce" compliance with the tax laws in bankruptcy cases. *Nicholas* v. *United States*, 384 U.S. at 694. By effectively ensuring that claims for postpetition penalties will not be paid from the assets of bankruptcy estates, the decision in this case would allow debtors-in-possession and trustees to disregard their legal obligations with impunity.[9] Allowing violations of the law to go unsanctioned and undeterred is neither "fair," nor "equitable," nor good "policy"—as Congress authoritatively determined by providing first priority for the payment of such claims. As this Court has recognized, the priority for postpetition tax penalties in bankruptcy exists precisely to ensure that debtors abide by the same rules of law that apply to every other business

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[9] The court of appeals erred in suggesting (Pet. App. 19a) that the tax penalties involved in this case can be collected by the government even if that claim is subordinated in the liquidation proceedings. The court reasoned that ultimate collection is assured because the "debtor-in-possession remains liable individually for the postpetition tax penalties" (*ibid.*). In making that statement, however, the court seems to have forgotten that this case involves a liquidation under Chapter 7. After such a liquidation, the debtor will have no assets available to pay any unsatisfied, subordinated tax penalty claim.

(including those with whom they compete). *Nicholas* v. *United States*, 384 U.S. at 694; *Boteler* v. *Ingels*, 308 U.S. at 61. See also *United States Department of Interior* v. *Elliott*, 761 F.2d 168, 171 (4th Cir. 1985).[10]

3. a. Other courts have also recently held that "principles of equitable subordination" are *not* confined to remedying creditor misconduct and instead permit courts categorically to subordinate "penalty" claims to the claims of other creditors who have incurred an "actual loss" (Pet. App. 20a). See *Burden* v. *United States*, 917 F.2d at 119-120; *In re Virtual Network Services Corp.*, 902 F.2d 1246, 1248-1250 (7th Cir. 1990); *Schultz Broadway Inn* v. *United States*, 912 F.2d 230, 232-234 (8th Cir. 1990); *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (10th Cir. 1995), cert. granted, No. 95-325 (Dec. 1, 1995). In these other cases, as here, the courts reasoned that subordination of a tax penalty claim is appropriate to ensure that payment of the penalty does not reduce the assets available for other claimants.

In so holding, these courts acknowledged that, prior to enactment of the Bankruptcy Code in 1978, the "existing case law" had held that the doctrine of equitable subordination required a showing of creditor misconduct. See, *e.g.*, *In re Virtual Network*

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[10] In *United States Department of Interior* v. *Elliott*, the court further explained the rationale for granting statutory priority to claims for postpetition penalties even though such claims may deplete the assets available to other creditors. Creditors may influence the debtor-in-possession or trustee to allow such penalties to accrue and should not be permitted to benefit from the false economies recognized by the estate through its failure to comply with applicable nonbankruptcy law. 761 F.2d at 171.

Services Corp., 902 F.2d at 1248, citing *Pepper* v. *Litton*, 308 U.S. at 304-305. The courts also recognized that Congress intended such "existing case law" to apply in any future elaboration of the "principles of equitable subordination" (902 F.2d at 1248; Pet. App. 11a). They reasoned, however, that the history of the 1978 Bankruptcy Code indicates that such older authority is not necessarily binding because "Congress intended courts to continue developing the principles of equitable subordination." *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1158, citing *In re Virtual Network Services Corp.*, 902 F.2d at 1249-1250. The courts relied for this conclusion on the portion of the floor statement of Representative Edwards which states (124 Cong. Rec. 32,398 (1978)):

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle.

Read as a whole, however, this sentence cannot logically be understood to suggest that courts may, in the "development of this principle," establish "principles of equitable subordination" that *conflict* with the "existing case law" that, as of 1978, had concluded that equitable subordination could *not* be applied to discard the categorical classifications of priorities that Congress enacted in the Code. Such a reading would place one part of that sentence at war with the other part.

Instead, this sentence from the floor statement indicates only that equitable subordination is a judicially created remedy that should be applied compatibly with the prior case law. The statement

cannot properly be read—as the court read it in this case (Pet. App. 18a)—as an invitation to *depart* fundamentally from prior case law by substituting the court's judgment about the comparative equities of classes of claims for the judgment that Congress itself has made.

b. The only authority cited by these courts as evidence of the "developing" principles of equitable subordination is the Second Circuit's decision in *In re Stirling Homex Corp.*, 579 F.2d 206 (1978), cert. denied, 439 U.S. 1074 (1979). In that case, the court of appeals held that the claims of shareholders who alleged that they were defrauded in purchasing stock of the debtor should be subordinated to general unsecured claims because "the equities favor the conventional general creditors rather than the allegedly defrauded stockholders." *Id.* at 213. The court noted that the claims of these stockholders for the recovery of their capital contributions are claims asserted in their capacity *as shareholders*. *Ibid.* The court held that the claims of shareholders brought in their capacity *as shareholders*, rather than in the capacity of a trade or business creditor, should not be treated on a parity with the claims of general unsecured creditors. *Ibid.*[11] In so holding, the court cited and relied (*ibid.*) on the authority of *Newton National Bank* v. *Newbegin*, 74 F. 135, 140 (1896), where the Eighth Circuit stated that the temptation for stockholders to attempt to "lay aside the garb of a

[11] *Stirling Homex* involved an attempt by equity shareholders who allegedly were defrauded in the purchase of the debtor's securities to *elevate* their priority in the corporate bankruptcy from last priority (as equity holders) to that of unsecured creditors (as tort claimants). 579 F.2d at 211-213.

stockholder, on one pretense or another, and to assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion."

Other courts have suggested that *Stirling Homex* is an example of a "developing" principle of equitable subordination under which courts should make a "case-by-case" evaluation of the equities and should not require actual proof of creditor misconduct. In *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, 53 F.3d at 1159, quoting *In Re Virtual Network Services Corp.*, 902 F.2d at 1250, the court broadly stated:

> [Section] 510(c)(1) authorizes courts to equitably subordinate claims to other claims on a case-by-case basis without requiring in every instance inequitable conduct on the part of the creditor claiming parity among other unsecured general creditors.

But nothing in *Stirling Homex* provides support for the proposition that courts may apply "equitable subordination" categorically to alter the distribution scheme that Congress enacted. The Second Circuit did not mention, much less question, the well-established case law holding that courts may not disregard the statutory priority scheme based on their contrary view of what is "fair" or "just." Instead, the decision in *Stirling Homex* was based upon the necessity of determining whether the claims of the shareholders were for the recovery of capital—and therefore to be paid only *after* general unsecured claims—or were instead business and trade claims properly to be treated on a parity with the general unsecured claims brought by strangers to the

corporation. The Second Circuit concluded in *Stirling Homex* that the claims of shareholders that stem from their status *as shareholders* are capital in nature and are therefore subordinated, under ordinary priority principles, to creditor claims. 579 F.2d at 213. See, *e.g.*, *Louisville Trust Co.* v. *Louisville, N.A. & C. Ry.*, 174 U.S. 674, 684 (1899) (noting the "familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors").

Stirling Homex is thus a particular application of, not a negation or nullification of, the statutory priority classification scheme that Congress has enacted.[12] Under that scheme, the interests of shareholders in the capital of the corporation is compensated only *after* the claims of general unsecured creditors are paid. See 11 U.S.C. 726(a)(6).

4. The doctrine of equitable subordination does not permit courts to act as committees of legislative review to promulgate priority schemes that are more closely aligned with their view of "fairness or * * * justice" (Pet. App. 19a). The categorical judicial re-evaluation of the "equities" of competing classes of claims authorized by the decision of the court of appeals in this case would create harmful uncertainties for private, as well as public, creditors. An unfettered "equitable" authority to adjust statutory priorities to enhance "fairness" would threaten "the financial community [by calling] into

[12] The rule articulated in *Stirling Homex* was codified in Section 510(b) of the Bankruptcy Code (11 U.S.C. 510(b)) and was described in the 1978 floor statement of Representative Edwards as an example of "existing case law." See Pet. App. 11a.

question the future of bankruptcy priority." Note, *No Fault Equitable Subordination: Reassuring Investors That Only Government Penalty Claims Are At Risk*, 34 Wm. & Mary L. Rev. 487, 488 (1993). Under the theory applied by the court of appeals in this case, it could be questioned whether, for example, claims for punitive damages would be regarded as subject to subordination because "inequitable" (in the sense of not involving "actual losses" (Pet. App. 19a)) or, instead, entitled to preferential treatment because "equitable" (in the sense of being designed to promote the public purpose of deterring malicious behavior). Similarly, postpetition governmental "penalty" claims designed to deter violations of health and safety regulations would plausibly be subject to subordination on the theory adopted by the court of appeals in this case—because they do not compensate the government for "pecuniary loss" and may reduce the recovery of other claimants (*ibid.*).

The establishment of categorical priorities among competing, innocent claimants has never been the function of the judiciary in bankruptcy cases. In the Bankruptcy Code itself, Congress specified the priorities that innocent claimants are to receive. See 11 U.S.C. 507, 726. By ignoring those statutory priorities—and, indeed, adopting a precisely opposite set of priorities in this case—the decision of the court of appeals represents a marked departure both from the common understanding of "equitable" authority and from the specific understanding of the doctrine of "equitable subordination" that Congress codified in 1978 in Section 510(c) of the Bankruptcy Code.[13]

[13] This case will be argued in tandem with *United States* v. *Reorganized CF&I Fabricators of Utah, Inc.*, No. 95-425,

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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which presents a closely analogous question concerning the proper scope of the "principles of equitable subordination" in bankruptcy cases. We have furnished a copy of the brief for the United States in *Reorganized CF&I Fabricators* to counsel for the respondents in this case. We have also furnished a copy of the brief for the United States in this case to counsel for the respondents in *Reorganized CF&I Fabricators*.